

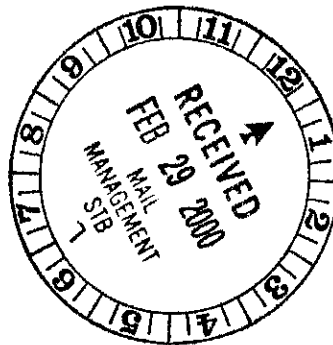
February 29, 2000

Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, NW  
Washington, DC 20423-0001

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Office of the Secretary

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RE: Ex Parte No. 582: Public Views on Major Consolidations

Dear Secretary Williams:

Enclosed is the Alliance for Rail Competition's original written statement, ten copies of that statement and this letter and a diskette that includes files of this statement in Word and WordPerfect 5.x . Please post this statement on the STB's web site.

Thank you for your assistance in this matter.

Respectfully submitted,

*Diane Cuff*

Diane C. Duff  
Executive Director

**STATEMENT  
of the  
ALLIANCE FOR RAIL COMPETITION**

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BEFORE THE SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582  
**Public Views on Major Consolidations**  
March 7, 2000

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Office of the Secretary

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The Alliance for Rail Competition (ARC) commends the Surface Transportation Board (STB) for initiating this review of major railroad consolidations and the present and future structure of the North American railroad industry. For the past several years, ARC has represented the diversity of the rail customer community before Congress and the Board, pressing for significant pro-competitive changes to rail policy in recognition of the dramatically different appearance of today's rail industry compared to that which previously existed. Our organization and its mission have been defined by rail customers who have had growing concerns about deterioration in service performance, increases in rail transportation costs, monopolistic railroad behavior in both pricing and service, and the inability of captive rail customers to get either competitive choices among major rail carriers or adequate regulatory protection from monopolistic behavior.

Without any further consolidation activity among the remaining rail carriers, these issues would continue to be of tremendous concern to rail customers. However, the December announcement that Burlington Northern and Santa Fe Railway (BNSF) and Canadian National Railways (CN) intend to merge has raised the stakes. The subsequent reactions from other Class I

railroads and from this Board make it very clear that the next merger to be approved—regardless of the merger partners—will inevitably cause a domino effect, the outcome, in all likelihood, being a two-railroad system throughout North America, with extension of each system’s monopoly power over that which is exercised today.

That is a frightening proposition considering that in today’s system of two major eastern and two major western railroads, there is little true competition among carriers for a significant portion of their business and that economic regulation has not been sufficiently revised to compensate for what has become an exponentially increasing competitive void.

So long as today’s configuration remains in existence, the opportunity to address these problems with changes in the interpretation of existing rail policy is possible. However, should today’s Class I rail industry undergo any further consolidation—regardless of who the merger partners might be—rail policy, and the rail system itself, would require more far-reaching changes than those considered by ARC to date. No major merger—whether it’s the proposed BNSF-CN merger or two other Class I carriers—should be considered without system-wide changes to rail policy that would address what has now become an extensive record of customer complaints and widespread dissatisfaction. In other words, merger conditions that apply only to the merging carriers will not address the breadth of concern, and would most likely put one carrier at a significant disadvantage to the few remaining carriers. We need no further imbalances.

If this Board refuses to recognize that policies set 20 years ago, applied in an environment significantly different from the one we face today, are inadequate, the legislative debate over policy will undoubtedly move away from the problems with regulatory interpretation we have

been trying to address—such as whether a customer should be allowed to get a rate over a segment of a movement, or whether a customer could choose between two carriers in a terminal area where both those carriers operate—and move toward a more comprehensive public interest debate about how to best open the access to the railroads’ track structures and related plant so as to reintroduce universal competition. At this moment, a debate over pervasive access is not one that rail customers generally, or ARC specifically, relishes entering. Nonetheless, the prospect of further consolidations among any of the remaining major rail carriers without adoption of system-wide policy changes would leave rail customers with little choice. These are options that the Alliance for Rail Competition will continue to study thoroughly so we are prepared to enter such a debate should the need arise.

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### **STATUS OF THE RAIL INDUSTRY**

The discussion of downstream impacts of mergers must be based upon a brief review and assessment of the current composition and behavior of the rail industry.

#### **A. Four Mega-Railroads Overwhelmingly Dominate Railroad Traffic and Offer Extremely Limited Transportation Choice To Customers.**

The first basic element of this foundation is the increasing concentration of market power among Class I railroads. As shown in **Table No. 1**, attached to the end of this statement, the number of railroads has steadily declined throughout the 20th century, while at the same time, the percentage of traffic handled by the four largest railroads has steadily increased. Even since the Staggers Act -- legislation which was to encourage and rely on market competition -- the number of Class I railroads has declined by over 80% to just seven today, with four of those

railroads dominating the industry. In fact, the four largest railroads handle 95% of Class I railroad ton-miles, and undoubtedly control an even greater percent of the traffic. Thus, many rail-dependent customers are faced with either no choice of carriers, or a limited choice between two railroads. While, in the short run, a two-carrier choice might provide some competitive advantages to some, basic economic theory holds that in the long run, oligopolists and/or dual monopolists decide that an activity such as competitive (marginal) pricing is self defeating because it will be matched by the other supplier. Thus, a conscious parallelism of action results with customers, such as railroad shippers, having little or no choice of prices and service levels.

Another concern in regard to the increased concentration of railroad market power is that two railroads will comprise a majority in votes over such centralized intra-industry matters as car-repair billing rates, interline agreements, accounting rules, and policy positions. For example, even though shippers now supply more than half of all railroad cars, the railroad industry already requires private car owners to agree to be bound by the AAR Interchange Rules as a prerequisite to private car operation, and those rules are effectively set by the remaining Class I railroads. Individualism can be lost in a two-railroad collective that is adorned with significant assets, strong financial means, and inordinate staying power. The result is an uneven regulatory arena between railroads and their non-collective, rail-dependent customers.

B. Cost Savings of Mergers Have Been Overstated.

The second element of any objective assessment must acknowledge that railroad cost savings attributed to mergers have been significantly overstated. Such an acknowledgment will provide the proper perspective to prospective claims of merger savings, and allow regulatory

determinations to be made on the basis of more credible estimates of economic efficiencies versus the adverse impact of less railroad competition.

**Table No. 2** shows that the railroad industry has been in the throes of a long-term, downsizing trend. Quite simply, the industry was substantially over-built, and the miles of road owned and number of employees would have been significantly reduced even without mergers. Mergers were not responsible for crew reductions from four or more personnel down to two on-train employees. Mergers were not responsible for the elimination of cabooses. And mergers were not entirely responsible for the abandonment of light-density lines and related service. There is no dispute that railroad mergers have resulted in the realization of certain economies of scale and, to an even greater degree, density, but this is only one component of railroad unit-cost reductions. At the same time, the shrinkage of railroad competition associated with mergers has had an adverse impact on rail-dependent customers in the form of higher rates, and especially, service deficiencies.

#### C. Service Deficiencies and Price Distortions

The purpose of economic regulation is to control an industry in such a way that its behavior will resemble that of a competitive industry. Something is obviously amiss in regard to railroad regulation because the kinds of service deficiencies which have been documented over the past five years or so, following large mergers of Class I railroads, could never have prevailed in competitive industries. Furthermore, in competitive industries the individual companies do not price similar services so that they make an infinitesimal margin on some business while pricing other business at more than twice the level of costs. This is not to say that differential pricing is not practiced by virtually all businesses in the United States, but rather to suggest that

the span of profit margins in the railroad industry is much wider than in industries in competitive markets.

What is of major concern to rail-dependent shippers is that the railroad mergers were supposed to correct service deficiencies, rather than exacerbate them. Yet, we hear from railroad executives that the service problems are to be blamed on satiated yards and terminals. But, (rhetorically speaking), isn't this a railroad management problem? After all, consider the cost savings enjoyed by railroads as shown in **Table No. 3**. Railroad unit costs have declined dramatically over the past 60 years. Even since 1980, as Table No. 3 shows, "real" (constant-dollar) costs have declined by 63% from 5.32 cents per ton-mile to 1.98 cents per ton-mile. At the same time, as **Table No. 4** shows, railroad traffic, measured in ton-miles, increased -- going from 919 billion ton-miles in 1980 to 1.4 trillion ton-miles in 1998. With such enormous savings and constant traffic growths, why is there not enough capacity at terminals to adequately handle the traffic? Whose fault is this? Why do rail-dependent customers have to suffer? Adequate competition and, in the absence of such, effective regulation, would have gone a long way in ensuring adequate railroad service standards. This is not a matter of inadequate railroad earnings. The railroad industry has not been short of capital for many years.

#### D. Economic Regulation Has Not Compensated for the Growing Competitive Void

Some of the regulatory problems resulting in railroad pricing and service deficiencies are fairly obvious to rail-dependent customers. Maximum rate proceedings tend to go on for many years and are enormously costly and time consuming. The railroad revenue-adequacy determination has little, if any, credibility as both debt and equity capital is readily available to allegedly revenue-inadequate railroads. And such measures as stand-alone costs, the Uniform

Rail Costing System, and the cost of capital are laden with complexities, judgments, and questionable data. In short, there is no effective regulatory backstop for most rail-dependent customers.

This portion of the assessment is clearly supported by the outcome of the General Accounting Office analysis completed last February. According to their extensive surveying of rail customers, more than 70% noted that time, complexity and costs of filing complaints with the STB were such a barrier to regulatory intervention that they generally didn't even consider it to be an option. Similar findings were the result of an analysis completed by the American Enterprise Institute and Brookings Institute in December of 1999.

### **EXPERIENCE WITH MERGERS**

In considering further consolidation in the rail industry, it is impossible to ignore rail customers' recent experiences with other recent mergers that were supposed to offer tremendous improvements in service. In and of themselves, mergers are neither inherently good or bad. Their desirability depends on their impact on their customers and their benefits to society. In turn, the impact on customers depends on the economic characteristics of the merger, the level of railroad competitiveness in the marketplace, and the ensuing merger conditions established by the STB.

The customer is the focus for most other federal regulators as they evaluate a proposed merger. For example, consider the policy of the Federal Energy Regulatory Commission:



“Rather than requiring estimates of somewhat amorphous net merger benefits and addressing whether the applicant has adequately substantiated those benefits, we will focus on ratepayer protection. The merger applicant bears the burden of proof to demonstrate that the customer will be protected. This puts the risk that the benefits will not materialize where it belongs—on the applicants.”<sup>1</sup>

As another example, Federal Trade Commission Chairman Robert Pitofsky recently announced a tightening of merger reviews. While this tightening is not being characterized by the FTC as a “dramatic shift” in policy, Pitofsky has noted that the FTC’s actions are intended to “make transparent” agency procedures as they apply to divestiture proposals. These provisions include provisions that “would allow certain ‘crown jewel’ assets of a company to be seized if the company fails to make good on an FTC consent decree.”<sup>2</sup>

Unfortunately, no similar level of attentiveness to customer impact has been demonstrated in railroad merger situations. In fact, history shows us that, in the case of railroads, neither consumer protection nor competitive interests have been the litmus test for federal approval. Rather, the financial benefits to the railroads in question appeared to be the determining factor. In addition, there has never been an effort to assess a rail merger’s impact on customer service measures after the transaction has been complete. In the October 19, 1998 issue of *Traffic World*, former ICC general counsel Fritz Kahn wrote:

“The proponents of railroad mergers and acquisitions can be counted on to contend that their proposals will lead to improved transportation—better service and reduced costs—and, just as surely, the agency can be counted on to accept uncritically the railroads’ assurances. The question, however, is whether the

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<sup>1</sup> Inquiry Concerning the Commission’s Merger Policy Under the Federal Power Act: Policy Statement, III FERC Stats. & Regs. Para. 30,044, at 30,123 (1996).

<sup>2</sup> “FTC to Get Tough on Merger Reviews.” By James V. Grimaldi, Washington Post, page E1, February 17, 2000.

railroads' representations have been realized. Have the railroad mergers and acquisitions yielded the better service and reduced costs, and hence, lower rates which were the premise of the ICC's or STB's approval of the transaction? The STB doesn't know, just as the ICC didn't know. Neither one of them ever has studied the effects of a railroad merger or acquisition approved by it."

Nonetheless, a cursory review of the last several mergers clearly demonstrates that the projected benefits that supported proposed—and approved—mergers, generally have not been realized.

In summary, the rail customer's experience has been that railroad mergers have traditionally and consistently been proposed as being the panacea for all ills. Projected benefits typically range from huge cost savings to substantially improved service, and sometimes include the enhancement of competition. It is not surprising that, given such expectations, railroad customers often support such mergers, only to be disappointed with the ensuing reality. But then, another proposed merger comes along and the cycle is repeated. What occurs is that the expectations of the "next" merger outweigh the disappointments of the past merger. When a railroad virtually guarantees that the benefits from a proposed merger will provide shippers with the type of service they require, it is difficult to deny railroads the opportunity to fulfill their stated intentions. Yet, as previous merger opportunities have now come and gone, it has become clear that there is a significant gap between expectations and results. This gap can be illustrated by comparing the projected benefits of such mergers with the state of the railroad industry that currently exists. The following three examples demonstrate the point.

1. The merger of the Burlington Northern (BN) and Santa Fe (SF) railroads in mid-1995 was based on projected annual savings of \$450 million in operating and administrative expenses, and

the realization of another \$110 million in operating income on new revenue to be earned. After increasing its offer for the SF from \$2.6 billion to just over \$4.0 billion, BN reiterated the advantages of the merger which included: single-line service to all four major West Coast ports; the merging of Santa Fe's market strength in intermodal with BN's coal, grain and commodities traffic; and, administration efficiencies that will, among other things, allow the elimination of some 2,750 jobs. At the same time, BNSF was saddled with significant new debt that ultimately would have to be passed on to customers.

2. The merger between the Union Pacific (UP) and Southern Pacific (SP) railroads was consummated in September of 1996. UP claimed that the merger would "provide dramatic service improvements to shippers, greatly strengthen western rail competition, and help position American industry to be fully competitive domestically and internationally in the 21st Century." The merger was somewhat of a defensive action, as SP Chairman Anschutz acknowledged: "A combination with UP was inevitable for SP, after BN and Santa Fe agreed to merge." More specifically, the expected benefits of the merger were identified in the 1996 annual report of the Union Pacific Corporation (UPC), as follows:

The benefits flowing from this consolidation are multifold: routes will be shortened, often dramatically, congestion will be eliminated; and traffic flows will become more efficient on every major western corridor. The total annual operating income benefit to Union Pacific could reach more than \$820 million by the year 2001.

UPC went on to tout the expectation of improved on-time performance for shippers, much faster transit times, expanded single-line service, significantly reduced operating costs, shorter routes, better equipment and more reliable service, a significant reduction in congestion and delays, faster

and more dependable intermodal service, stronger rail competition in the West, and specialized use of parallel routes to improve traffic flow, transit times and reliability.

This Board does not need to be educated about the aftermath of this merger, but during its implementation, even UP President Ron Burns stated: “many shippers are experiencing unprecedented problems with service provided by our railroad.” At one point, Dr. Bernard Weinstein of the University of North Texas estimated the economic impact of that service crisis exceeded more than \$2 billion in the state of Texas alone, and that was long before service in the West improved.

3. The acquisition of Conrail by the CSX and Norfolk Southern (NS) railroads went into effect on June 1, 1999. While some cost savings were expected to be realized from the joint acquisition in spite of a \$20 billion acquisition premium, there were two major favorable expectations: (1) improved service to shippers due to increased direct-line competition between two railroads, and (2) traffic diversion from motor carriage. It’s worth noting that as CSX and NS increased their respective bid prices for Conrail, the anticipated benefits were “recalculated”, and magically, as the price of the acquisition increased, so did the anticipated benefits. Instead, rail customers have experienced system-wide service problems on both CSX and NS that, despite promises to the contrary, continue to this day. In some regions, such as Buffalo, service has been so bad that customers have been forced to shift production to other regions. Reports of rail customers being forced to divert rail traffic onto motor carriers would support the notion that the carriers have not only failed to take truck traffic off the road, but have more likely contributed to at least a short-term increase in truck traffic.

Representatives of both CSX and NS have acknowledged their troubles and, despite having two years to prepare, both carriers have chalked up their problems to “poor planning” and the fact that they “didn’t anticipate their customer’s needs.” Despite the system-wide service problems, both CSX and NS are in the process of increasing their rates, and cite shortages of track and equipment as providing the opportunity for them to do so.

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It is important to note that the recent CN merger with IC has been identified as having “gone off without a hitch.” However, this statement cannot be applied to operational changes required by the merger, as those changes didn’t begin until approximately two weeks ago. In fact, a key computer switchover has been postponed. In some previous mergers, service problems didn’t begin to be evident for as long as six months. Thus, no one can legitimately classify the relatively small CN-IC merger as an indication that mergers in this highly concentrated market can still be done without harming service or competition.

#### **MERGER POLICY RECOMMENDATIONS**

In considering any merger from this time on, the Board would more appropriately serve the public interest by responding to broader fundamental questions: What does our national economy require of its railroad system? How does the merger in question impact the ability of the rail system as a whole to meet the national need? What policy changes are necessary to ensure that the nation’s rail system is best positioned to live up to those requirements? Answering those kinds of questions would more appropriately focus this Board on protecting and

forwarding the interests of the consumers of railroad services—who provide the reason that railroads exist at all.

Thus, sound public policy toward future railroad mergers should be based on the following principles:

**1. A Viable Freight Railroad Industry is in the Public Interest**

Freight railroads are a national asset which have the ability to provide relatively low-cost, energy-efficient, and environmentally benign transportation service. Further, these railroads have a duty to serve all of their customers, without whom railroads would cease to exist. The best means for ensuring the railroad industry's viability is to encourage rail carriers to compete among themselves, as well as with other modes of transportation. Competition is the engine that drives the free enterprise system. It pressures suppliers (railroads) to be efficient and can help railroads grow traffic.

**2. The Net Impact on Customers Should be the Key Merger Criterion**

Even where economies of density are expected to be realized, railroad mergers should not be approved if the prospective cost reductions are offset by adverse service and/or rate impacts on railroad customers due to a diminishment of competition.

**3. Competitive Access is the Preferred Protection for Customers**

Railroad customers can be protected from the adverse effects of mergers through additional competitive access to captive customers served by the merged railroad, and/or by implementing effective economic regulation. Competitive access is preferable to regulation because it motivates carriers to be responsive to customer needs. Competitive access would benefit railroads in that the incumbents: (1) could charge adequate user fees, (2) would

experience traffic growth, and (3) would in turn realized newly-found economies of traffic density.

#### **4. Railroad Customers Need Safe Harbor Protection**

In the absence of effective railroad competition, economic regulation is necessary to insure that service is adequate and freight rates are reasonable. Opening access and economic regulation is not an either-or choice; they are parts of a whole.

#### **5. Railroad Mergers Are Not the Only Way to Lower Operating Costs**

Traffic growth is a key to economies of railroad track density. Aside from traffic growth, railroads can reduce costs through a wide variety of managerial and technological means. Railroads have controlled their costs by eliminating inefficient service, reducing crew sizes, changing operating and work rules, and employing new technology.

#### **6. Post-Merger Performance Must be Closely Monitored**

The STB shall establish procedures to measure post-merger performance and should issue an annual report of its findings for a period of ten years.

#### **7. Where Desirable Adjustment will be Made**

When railroad mergers cause unanticipated adverse impacts on customers, the situation can be rectified *post-merger*, by opening competitive access and/or making economic regulation more effective.

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ARC fully understands that the remedy for defective railroad markets is to be partially found in legislative change. However, the extent of that legislative remedy will be largely determined by the actions—or lack thereof—of this Board in reviewing further consolidations.

ARC also believes that the present railroad market distortions would not have occurred if an adequate public policy regarding mergers would have been developed and followed. It is not too late; the time to begin the change is now, and the STB has the power and authority to start the process. Thus, it is ARC's firm belief that the STB should undertake the following four steps before even considering any further major rail consolidations, again, regardless of the merger partners:

1. Adopt a merger policy similar to that advocated in this statement.
2. In light of the market power held by today's rail system configuration, re-examine the issues of so-called "bottleneck" rates and decisions relating to access in terminal areas.
3. Change the revenue-adequacy criterion to a simple measure of "allowable return-on-equity," similar to the public utility industry, and
4. Work with rail customers and Congress to develop an appropriate method for providing protections for small captive shippers that can be passed into law.

ARC stands ready to work with the members of this Board in support of such pro-competitive, consumer-oriented changes.



**Table No. 1**

**DOWNSIZING OF THE RAILROAD INDUSTRY  
(Class I Railroads)**

<b>Year</b>	<b>Miles of Road Owned (000)</b>	<b>No. of Railroads</b>	<b>No. of Employees (000)</b>
<b>1907</b>		<b>230</b>	
<b>1916</b>	<b>254</b>		
<b>1920</b>			<b>2,148</b>
<b>1929</b>	<b>230</b>	<b>162</b>	<b>1,661</b>
<b>1980</b>	<b>165</b>	<b>36</b>	<b>458</b>
<b>1985</b>	<b>146</b>	<b>23</b>	<b>302</b>
<b>1990</b>	<b>120</b>	<b>14</b>	<b>216</b>
<b>1995</b>	<b>108</b>	<b>11</b>	<b>188</b>
<b>1998</b>	<b>101</b>	<b>9</b>	<b>178</b>
<b>1999</b>		<b>7</b>	

**Source:** Association of American Railroads, Railroad Facts (annual publication) and Railroad Transportation, A Statistical Record, 1911-1951. Interstate Commerce Commission, Statistics of Railways in the United States, For The Year Ended 1929, 1930 and annual reports.

**Table No. 2**

**INCREASING MARKET CONCENTRATION  
WITHIN THE RAILROAD INDUSTRY  
(Class I Railroads)**

<u>Year</u>	<u>Number of Railroads</u>	<u>% Ton-Miles Carried By Four Largest Railroads</u>
1929	162	23%
1940	134	27
1950	129	25
1960	109	25
1970	73	34
1980	36	43
1985	23	47
1990	14	66
1995	11	69
1998	9	87
1999	7	95

**Source:** Association of American Railroads, Analysis of Class I Railroads (annual publication). Interstate Commerce Commission, Statistics of Railways in the United States, For The Year Ended 1929, 1930.

**Table No. 3**

**DECLINING RAILROAD OPERATING EXPENSES  
(Class I Railroads)**

<b>Year</b>	<b>Operating Expense Per Ton-Mile</b>	<b>Railroad Inflation (1998 = 100)</b>	<b>“Real” Expense Per Ton-Mile</b>
<b>1939</b>	<b>1.04 cents</b>	<b>3.2</b>	<b>32.5 cents</b>
<b>1980</b>	<b>2.75</b>	<b>51.7</b>	<b>5.32</b>
<b>1985</b>	<b>2.74<sup>1</sup></b>	<b>67.9</b>	<b>4.04</b>
<b>1990</b>	<b>2.37</b>	<b>81.4</b>	<b>2.91</b>
<b>1995</b>	<b>1.99<sup>2</sup></b>	<b>93.4</b>	<b>2.13</b>
<b>1998</b>	<b>1.98<sup>3</sup></b>	<b>100.0</b>	<b>1.98</b>

- 
1. 2.85 cents adjusted for \$809 million of special charges taken as operating expenses.
  2. 2.12 cents adjusted for \$1.7 billion of special charges taken as operating expenses.
  3. 2.02 cents adjusted for \$520 million of special charges taken as operating expenses.

**Table No. 4**

**INCREASING RAILROAD TRAFFIC  
(Class I Railroads)**

<u>Year</u>	<u>Tons Originated</u> (Millions)	<u>Revenue</u> <u>Ton-Miles</u> (Billions)
1929	1,339	447
1955	1,396	624
1970	1,484	765
1980	1,492	919
1985	1,320	877
1990	1,425	1,034
1995	1,550	1,306
1998	1,649	1,377

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